No. 21037

IN THE

United States Court of Appeals For the Ninth Circuit

UNIVERSITY PROPERTIES, INC.
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION TO REVIEW A DECISION OF THE TAX COURT OF THE UNITED STATES

OPENING BRIEF OF PETITIONER

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SUBJECT INDEX

TABLE OF CASES

STATUTES AND RULES

TEXTBOOKS

OTHER AUTHORITIES

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Jurisdictional Statement

This action was commenced by the petitioner, University Properties, Inc., against the respondent, the Commissioner of Internal Revenue, in the Tax Court of the United States upon a petition for redetermination of asserted deficiencies of $40,114.29 and $38,573.53 in petitioner's income taxes for its fiscal years ended October 31, 1961 and October 31, 1962, respectively. (R-1-11)

Following a decision and order by the Tax Court affirming the said deficiencies, (R-38) a petition for review thereof by the Ninth Circuit was filed. (R-39-42)

The following citation contains reference to the statutory authority believed by petitioner to sustain the initial jurisdiction of the Tax Court and the jurisdiction to review by this court:

"This is a petition for review or a Tax Court decision sustaining the Commissioner's determination of deficiency in income taxes of the petitioner . . . Both the Tax Court and this court have jurisdiction. 26 U.S.C. (IRC, 1939) §1141(a); (IRC, 1954) §7482(a)."

Holtz v. Commissioner of Internal Revenue, 268 F.2d 865, 866, 867 (9th Cir., 1958).

STATEMENT OF THE CASE AND QUESTIONS PRESENTED

General Background

Respondent determined deficiencies in petitioner's income taxes for its fiscal years ended October 31, 1961 and October 31, 1962 in the respective amounts of $40,114.29 and $38,573.53. These asserted deficiencies resulted from the disallowance by the respondent of certain $80,000 payments made by petitioner to its lessor, the University of Washington, pursuant to a supplemental lease agreement dated February 5, 1958 wherein such payments were referred to as "additional rentals." (Jt. Ex. 4-D)

Petitioner contends that the said payments were current rents or, alternatively, ordinary and necessary business expenses and deductible in full for the years in which paid. The respondent contends that said payments were capital expenditures for the acquisition of certain property added to petitioner's leasehold by the said supplemental lease agreement, or were advance rentals, to be deducted ratably over the remaining term of the lease.

Petitioner, a private corporation, was incorporated under the laws of the state of Delaware on July 6, 1953.

Its principal offices are located in Seattle, Washington. (R-19) Petitioner's income tax returns for the years here in question were filed with the District Director of Internal Revenue, Tacoma, Washington. (R-19) Copies of said returns appear as Joint Exhibits 2-A and 2-B.

The Original Lease

On July 18, 1953, petitioner entered into a lease agreement with the University of Washington, lessor, demising a portion of a tract located in the heart of downtown Seattle to petitioner for a term of 35 years from November 1, 1954. (R-21; Jt. Ex. 3-C) Said lease provided for fixed rents to be paid for the lease years commencing November 1, 1954, November 1, 1955, November 1, 1956 and November 1, 1957 of $1,600,000, $1,700,000, $1,700,000, and $1,800,000, respectively. Thereafter, for each succeeding fiscal year a percentage rent was to be paid by petitioner on the total gross rental income from the demised premises. This amount had reference to the gross rental income collected by petitioner from tenants in the operation of the premises. (R-21)

Under the said percentage rental provisions, a minimum guaranteed rent of $1,000,000 per year was reserved. This minimum rental was subject to abatement in the event that, for any reason other than the default of the lessee, any portion of the demised premises should not be capable of being occupied, operated or used by the lessee. In such event, the minimum rent was to be reduced for the period of time such space remained untenantable in the amount which would have been lessor's percentage rental for the untenantable space, if such space

had been tenantable. (Ex. 3-C, pp. 7, 8)

Petitioner was obligated by said lease to operate the various structures and buildings then or thereafter constructed on the demised premises in such a manner as not to injure the reputation thereof and to maintain the demised premises and area as a center of store and office buildings of the first class in the city of Seattle. (Ex. 3-C, p. 8)

The original lease also contained a provision for a new building fund under which the lessee agreed to study from time to time the desirability and economic necessity for the construction of new buildings and capital alterations and to make recommendations to the lessor with reference thereto. The lessor had the right to determine what buildings and capital improvements would be made and the lessee would be responsible for the construction of such buildings and improvements with the right to be reimbursed from the new building fund for the cost thereof. (Ex. 3-C, p. 16)

The Post Office Tract Acquisition

On January 29, 1958 petitioner's lessor acquired from the United States, a parcel of land some 4,400 sq. ft. in area which formerly comprised a part of a United States Post Office site. This 4,400 sq. ft. parcel, hereinafter referred to as the Post Office tract, abutted the premises demised under the lease of July 18, 1953 to petitioner. As consideration for the Post Office tract, petitioner's lessor agreed to demolish the old Post Office Building and to construct a new Post Office Building on the part of the site retained by the Federal government. (R-21, 22)

The Douglas Building, smallest and least profitable of the buildings located on the premises demised under the original lease occupied the site adjacent to the Post Office tract. It was decided by the University of Washington and petitioner that the Douglas Building would be demolished and a new building, to be known as the Washington Building, would be constructed on the site of the Douglas Building as expanded by the Post Office tract. (R-22)

On February 5, 1958, a supplemental lease agreement between the University of Washington and petitioner added the Post Office tract to the property covered under the original lease. (Jt. Ex. 4-D) The supplemental lease agreement recited the purpose of said agreement as being to preserve and improve the status of the premises previously demised to petitioner as a business center of the first class by the replacement of the Douglas Building with a new building to be located on the Douglas Building site enlarged by the addition of the adjoining Post Office tract. (Jt. Ex. 4-D, p. 1)

The consideration for the inclusion of the Post Office tract property into petitioner's leasehold was stated in said supplemental lease agreement to be petitioner's assumption of its lessor's undertakings and agreements with respect to the construction of the new Post Office building for the United States of America on the portion of the Post Office site retained by the United States. (Jt. Ex. 4-D, p. 2)

It was separately stated in said supplemental lease agreement that petitioner, lessee, would pay to the lessor the sum of $80,000 on November 1, 1960; and the sum of $80,000 on November 1, 1961; and the sum of $80,000

on November 1, 1962, as additional rentals over and above all rentals provided for under the terms of the original lease. (Jt. Ex. 4-D, p. 3)

Construction of the Supplemental Lease Agreement

Petitioner and its lessor each treated the payments here involved as current rent payments in their respective books of account. (R-22)

The supplemental lease agreement provided that as to any new structure located on the Post Office tract, such structure would be subject in all respects to the rights and obligations of the parties thereto as set forth in the original lease with respect to the original structures upon the property demised under the said original lease. (Jt. Ex. 4-D, p. 3) Thus, the original lease and the supplemental lease agreement were to be construed together to arrive at a determination of the rights and obligations of the parties thereto.

In its Opinion, the Tax Court concluded that the designation by the parties to the supplemental lease agreement of the payments in question as rentals was not controlling. (R-32)

The Tax Court further inferred that during the period in question, the Douglas Building would be in the process of destruction and the Washington Building in the process of construction and the site, therefore, nonincome producing (R-33) In fact, the Washington Building was formally opened for occupancy on June 2, 1960. (R-22) The Tax Court further inferred that the rent abatement provision of the original lease would be applicable to the period in question so that "it would seem logical that instead of paying additional rent for these three years, petitioner's

ent would have been reduced while the property was non-income producing, rather than increased." (R-34) Petitioner made rent payments for the years here in question which exceeded the one million dollar minimum yearly rental guaranteed in the original lease (Jt. Ex. 1-A, p. 1 and 2-B, p. 1), which payments rendered said rent abatement provision inapplicable to said years.

The Tax Court relied principally on such cases as *Main & McKinney Building Co. v. Commissioner,* 113 F.2d 81 and *Southwestern Hotel Co. v. United States,* 115 F.2d 386 to conclude that the payments here in question could be construed as advance rentals. (R-32, 33)

Deductibility of Payments as Ordinary and Necessary Business Expenses

Petitioner argued in the alternative that the payments in question should be deductible as ordinary and necessary business expenses. The supplemental lease agreement demonstrated the obligation of petitioner to maintain the demised premises, including that portion upon which the Douglas Building was located as a center of store and office buildings of the first class and that in order to accomplish that purpose to preserve and improve the status of the tract as a business center of the first class, a new building should be located on the site formerly occupied by the Douglas Building, as enlarged by the addition of the Post Office tract. (Jt. Ex. 4-D, p. 1) The Tax Court concluded that assuming that the $80,000 payments were made for the acquisition by petitioner of the Post Office tract portion of its leasehold, such payments were not ordinary and necessary business expenses of the petitioner for the reason that such expenses were

not incurred in the everyday operation of petitioner's business and that the same were not required to be made. (R-36)

QUESTIONS PRESENTED

On the basis of the above and foregoing statement of the case, the following questions are presented:

1. Did the Tax Court err in refusing to accept the characterization of the payments in question of the parties to the supplemental lease agreement as current rentals?

2. Did the Tax Court err in its tacit finding that the premises in question would be non-income producing during the fiscal years ended Oct. 31, 1961 and Oct. 31, 1962, here involved due to the destruction of the Douglas Building and the construction of the Washington Building?

3. Did the Tax Court err in inferring that the rent abatement provision of the original lease would be applicable to the premises in question during the periods here in question?

4. Did the Tax Court err in relying on the *Main & McKinney Bank Building* and the *Southwestern Hotel Company* cases, *supra,* in concluding that the designation of the payments by the parties as current rentals could be disregarded?

5. Did the Tax Court fail to apply the appropriate legal standard to the facts of this case in order to determine whether the payments in question were ordinary and necessary business expenses under 26 U.S.C.A. §162 (a), Int. Rev. Code of 1954?

SPECIFICATIONS OF ERROR

1. The Tax Court erred in concluding that the payments were advance rentals or capital expenditures. (R-32)

2. The Tax Court erred in disregarding the parties' characterization of the payments as current rentals. (R-32)

3. The Tax Court erred in considering the rent abatement clause of the original lease in construing the supplemental lease agreement. (R-33, 34)

4. The Tax Court erred in its finding that the Douglas Building site as enlarged by the Post Office tract was non-income producing during the fiscal years in question. (R-33, 34)

5. The Tax Court erred in relying on cases cited at R-32, 23 to support its conclusion that the payments here in question were advance rentals or capital expenditures.

6. The Tax Court erred in its tacit conclusion of law that sums paid for untenantable property cannot be considered current rents.

7. The Tax Court erred in concluding that an "ordinary and necessary" business expense under 26 U.S.C. §162 is one which is required and made in the everyday operation of a taxpayer's business. (R-36)

8. The Tax Court erred in concluding that the payments herein were not ordinary and necessary business expenses.

SUMMARY OF THE ARGUMENT

I. The Tax Court erred in concluding that the payments were not current rentals.

A. The Tax Court erred in disregarding the purpose of the payments as current rentals.

B. The Tax Court's implied finding that the rent abatement clause was applicable to the transaction in question is clearly erroneous.

C. The Tax Court erred in its tacit conclusion of law that sums paid for untenantable property cannot be considered current rents.

D. Cases cited by the Tax Court do not support its conclusions that the payments were advance rentals or capital expenditures.

E. This court's review is not limited by the "clearly erroneous" rule.

II. The Tax Court erred in concluding that the $80,000 payments were not deductible as ordinary and necessary expenses under Int. Rev. Code 1954, 26 U.S.C. §162(a).

A. The Tax Court applied an erroneous standard of deductibility.

B. The evidence supports the deductibility of the payments as ordinary and necessary business expenses.

ARGUMENT

I. The Tax Court Erred in Concluding That the Payments Were Not Current Rentals

A. The Tax Court erred in disregarding the purpose of the payments as current rentals.

In 2 Mertens, *Law of Federal Taxation*, §12.36, it is stated:

"Where the lessee continues to occupy the premises under a new or modified lease, the amount paid by the lessee should be either deductible in full in the year of payment or amortized over the life of the lease depending on the underlying purpose of the payment. Where the payment is not required as a condition to the rental of the property in the future and where the parties specifically agree that the payment is unconditional and is earned at the time it is made, the payment should not be treated by the lessee as prepaid rental or as the cost of acquiring a new or modified lease and should not be spread over the period of the lease."

The controlling statutory guide herein is 26 U.S.C.A. §162, (I.R.C. 1954) which provides:

"(a) In General—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including— * * * (3) rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity."

The basic problem is, therefore, one of characterizing the payments here in question as current rental expenses or as capital expenditures; and this characterization is dependent upon the underlying purpose for the payments. Thus, the inquiry here is whether the underlying purpose of the payments was to secure the future use and possession of the leasehold property added by the supplemental lease agreement or whether the sums paid were consideration for the current use or possession of the demised premises.

The consideration for petitioner's right to the future use and possession of the portion added to the petitioner's

original leasehold is clearly stated in the supplemental lease agreement.

> "Whereas, lessor entered into said contract with the General Services Administration of the United States of America upon the understanding and agreement with lessee that the portion of the present Post Office site and the rights and privileges in connection therewith to be acquired by the lessor would be added to and incorporated in the Metropolitan Tract area covered by said lease of July 18, 1953, subject to all of the terms and conditions of said lease, and that *in consideration therefore lessee would undertake to fulfill and perform all of lessor's undertakings and agreements with respect to the construction of the new Post Office Building for the United States of America* * * *". (Emphasis supplied) (Jt. Ex. 4-D, p. 2)

On the other hand, the questioned $80,000 payments were provided for under a separate heading and identified by the parties as "rentals."

> "2. Lessee will pay to the lessor the sum of $80,000 on November 1, 1960; the sum of $80,000 on November 1, 1961; and the sum of $80,000 on November 1, 1962, as additional rentals over and above all rentals provided for under the terms of said lease." (Jt. Ex. 4-D. p. 3)

The parties also demonstrated the purpose and mutual characterization of the payments as current rentals by so treating them in their respective books of account. (R-22) Assuming that the purpose for the payments was not clearly stated in the supplemental lease agreement, the mutual construction of the payments by the parties is compelling evidence of their characterization of the payments as current rents. The following rule of construction is stated in 17 Am. Jur. 2d, *Contracts*, p. 683-685, §274:

> "In the determination of the meaning of an indefinite or ambiguous contract, the construction placed upon the contract by the parties themselves is to be considered by the court. Unquestionably, the practical construction or uniform conduct or practice of the parties under a contract is a consideration of much importance in ascertaining its meaning, and that consideration is entitled to great, if not controlling, influence in ascertaining the parties understanding of the contract terms and language, since the parties are in the best position to know what was intended by the language employed."

In *Hyde Park Realty, Inc. v. Commissioner of Internal Revenue,* 211 Fed. 462 (2nd Cir., 1954), the court, in determining whether the payments there in question were to be considered as a reduction in the purchase price of certain real property or as rentals, relied upon the fact that "There can be no doubt on the record that both parties treated the sum as rent" (p. 463) to conclude that the payments made were in fact current rentals. Here also, the subsequent, harmonious treatment of the $80,000 payments by both parties is compelling evidence of the proper characterization thereof as current rentals.

Where, as here, the parties have dealt at arms-length and the transactions are not illegal or contrary to public policy, "nor on their face designed as an ingenious scheme or devise to avoid payment of taxes," the purpose and characterization of the payments as set forth in the parties' written agreement will control. *Western Contracting Co. v. Commissioner of Internal Revenue,* 271 F.2d 694, 699 (8th Cir. 1959).

In respect to the designation of the purpose for the payments here involved, "the parties had full liberty to contract as they pleased." *Benton v. Commissioner of*

Internal Revenue, 197 F.2d 745, 752 (5th Cir. 1952).

Here also, the Tax Court is not at liberty to "make a new agreement for the parties," to disregard the parties' stated consideration for the acquisition of the additional leasehold property, to disregard their designation of the $80,000 payments as rentals, and to ignore the subsequent uniform treatment of the payments by both parties to the Supplemental Lease Agreement as current rents.

The Tax Court's statement that "The supplemental lease agreement makes no explanation of why the 'additional rentals' were to be paid" (R-33), is clearly refuted by the above facts. Moreover, it is extremely unlikely in common experience that a "reason" for the designation of a payment as rental would be stated in a lease agreement because the terms "rent" or "rental" by definition set forth the reason for the payment as being consideration for the use or occupation of property, *Black's Law Dictionary,* 4th Ed., 1957.

The purpose of the payments as shown by the supplemental lease agreement as written and construed by the parties is vividly disclosed by the record as consideration for the current use and possession of the premises. The above cited authorities demonstrate that to disregard such purpose is error as a matter of law.

B. The Tax Court's implied finding that the rent abatement clause was applicable to the transaction in question is clearly erroneous.

The following excerpts from the Tax Court's opinion are quoted at length to illustrate the extent to which the Tax Court relied upon the rent abatement clause of the

lease agreement of 1953 (This clause appears at Jt. Ex. 3-C, pp. 7, 8.)

> "Petitioner would receive no income from the use of the property added to the original lease during the years here involved, at least until the Washington Building was completed and rented." (R-33)

> "Under the terms of the original lease, if any of the demised buildings were to become untenantable during the terms of the lease, the rental paid by the petitioner to the lessor was to be reduced while such condition prevailed. It would seem logical that instead of paying additional rents for these three years, petitioner's rent expense would have been reduced while the property was non-income producing, rather than increased. Of course, this would have been the situation while the Douglas Building was being built, except for the payments here involved." (R-34)

> "We do not think it reasonable, likely or a fact that petitioner would pay $80,000 per year additional rental for the leased property during the years here involved, *when the property would produce less rental income to petitioner than before. . . .*" (Emphasis supplied) (R-34)

The facts assumed by the above statements are (1) that the premises demised by the supplemental lease agreement together with the site occupied by the Douglas Building were non-income producing during the fiscal years here involved and (2) that the rent abatement clause of the original lease agreement was applicable to the transactions contemplated by the supplemental lease agreement.

First, the assumption that the premises were non-income producing during the periods in question is absolutely contrary to the evidence. The construction of the Washington Building was completed and the

building formally opened to occupancy on July 2, 1960 (R-22), whereas the first additional rental payment under the supplemental lease agreement was payable for the fiscal year November 1, 1960 to October 31, 1961. (Jt. Ex. 4-D, p. 3)

Secondly, the rent abatement clause of the original lease agreement provided in part:

> "It is further agreed that if for any reason other than default of lessee, any portion of the demised premises shall not be capable of being occupied, operated, or used by the lessee, the annual *minimum guaranteed rent* shall be reduced for the period of time said space remains untenantable in the amount of what would have been lessor's percentage rent from the untenantable space if said space had been tenantable. . . ." (Emphasis supplied) (Jt. Ex. 3-C, p. 8)

Thus, only the minimum guaranteed rent ($1,000,000 per year during the fiscal years in question (Jt. Ex. 3-C, p. 4)) was to be abated. The abatement clause would not be applicable in the year in which rent otherwise payable by petitioner exceeded $1,000,000. During the fiscal years in question, the rents paid by petitioner to its lessor were $1,852,413, and $2,010,929, respectively (Jt. Ex. 1-A, p. 1 and 2-B, p. 1, respectively).

Even if the factual bases for the Tax Court's opinion were accurate, it is clear that the rent abatement clause would be inapplicable to the transaction contemplated by the supplemental lease agreement. That agreement provided that "any new structure located" on the Post Office Tract "shall be subject in all respects to the rights and obligations of the parties as set forth in said lease

with respect to the original structures on the demised premises." (Jt. Ex. 4-D, p. 3). The rent abatement provision was thus not intended to apply to the Post Office Tract while no "new structure" was located thereon. Thus, the rent abatement clause, even if otherwise applicable, would not apply to the Post Office Tract unless and until a new structure, completed thereon, subsequently became untenantable.

C. The Tax Court erred in its tacit Conclusion of Law that sums paid for untenantable property cannot be considered current rents.

There is inherent in the foregoing quotations from the Tax Court's opinion, *supra*, p. 15, the legal premise that sums paid for the use of temporarily nonincome producing property are non-deductible as current rentals. Even if it were true that the premises added by the supplemental lease agreement were non-income producing during the periods in question, such fact would not preclude the treatment as current rents of monies paid for the use of such premises by a petitioner. In *Flambeau Plastics Corp.*, 22 T.C.M. 112, T.C. Memo 1963-29, the commissioner took the position that the designation of monthly payments by the taxpayer to its lessor as "rents" was a mere label and did not represent the true character of the payments, which the commissioner characterized as capital expenditures for the acquisition of the leasehold. The lease agreement there contemplated the construction of a new building on the leased premises, and provided for a fixed yearly rental. The commissioner disallowed a rent payment deduction taken by the taxpayer for the period during

which the premises were untenantable because of the construction of improvements. The Tax Court held that the taxpayer was entitled to deduct the entire payment as rent, stating:

> "To hold otherwise, would be to say that a taxpayer who acquires the right to eventually use land by virtue of a lease arrangement must use it in the course of the carrying on of the trade or business before he may be said to have the use thereof under the statute. The words of §162(a)(2) are broader in their scope. The phrase 'for purposes of trade or business' of the taxpayer evidences a clear congressional intent that such use or possession need not be limited to the *carrying on* of a trade or business, but falls within the statutory intendment if the use *or* possession is for the *purposes* thereof. Certainly the petitioner was using the premises within the statutory meaning (when) immediately it began to oversee and supervise the construction of the building which construction clearly had no other purpose than to house the petitioner's business." page 115.

Thus, if it is assumed that the $80,000 payments were made for the use and possession of the Post Office tract portion of petitioner's leasehold while such property was non-income producing such fact would not render the payments nondeductible.

D. Cases cited by the Tax Court do not support its conclusion that the payments were advance rentals or capital expenditures.

In its opinion, the Tax Court relied primarily on *Southwestern Hotel Co. v. U.S.*, 115 F.2d 686, 688 (5th Cir. 1940), *Main & McKinney Building Co. v. Commissioner*, 113 F.2d 81 (5th Cir. 1940) and *Baton Coal Co. v. Commissioner*, 51 F.2d 469 (3rd Cir. 1931), affirming 19 B.T.A. 169, to support its conclusion that the pay-

ments here involved were not deductible by petitioner, but were advance rentals or capital expenditures. (R-32, 33)

The claimed deductions in each of the above cases involved payments made, or contracted to be made, as part of agreements covering the initial acquisition of a leasehold. On the other hand, we are here concerned with an incidental modification, by the supplemental lease agreement of the lease agreement of 1953 under which the principal portion of petitioner's leasehold was demised.

Moreover, in *Southwestern*, the court's conclusion that the claimed deductions were in fact advance rentals or capital expenditures was based, in part, upon the finding that the amounts so paid were *grossly disproportionate* to the "rentals" reserved for the later years of the lease term. The court in *Southwestern* stated as to the characterization of the payments claimed as deductions:

> "The determination of this ultimate question is reached by deciding whether the payments were rental for the use and occupancy of the premises during the particular year in which it was made, or whether it was advance payment of rental which exceeded the actual value of the use for the year in which it was paid, and which was made in consideration for a lease for a longer period of time. We think this question is clearly answered by an examination of the schedule of payments due under the mortgage debt. On May 1, 1940, a payment of $265,000 was due on the mortgage, and during that same tax year $18,000 was due to the lessor. Contrasted to that, in 1941 and each subsequent year, the total annual rental due was only $24,000 to $30,000. It is also true, that for each of the years that the payments on the mortgage debt were due, the total annual payments made in consideration of the lease were substantially larger than the rentals due after the

satisfaction of that debt. Under these circumstances, it is unreasonable to believe that the payment to the mortgagee, when added to the rent paid to the lessor, aggregated the amount paid for the rent paid for the premises during the tax year." Pages 687, 688.

And in the *Main & McKinney* case, the court observed:

"The error of petitioner's theory is made apparent by another view of the case. The only consideration moving from it to its grantor, the original lessee, after the cash payment, was the payment of the $10,000 per year for 25 years. If these payments are to be considered rentals rather than extended payments of the purchase price, the payment thereof at a specified rate entitled petitioner to use the premises for a period of 73 years without paying any rent therefor. Clearly, therefore, these payments, if rentals were advances returning benefits over the 98 year period of the lease, for which only aliquot deductions, commensurate with the ratio of the exhaustion of the lease, may be taken." page 114.

In *Baton Coal Co.*, the opinions of both the Board of Tax Appeals and the Circuit Court are so devoid of fact as to provide little, if any, basis for reliance thereon as authority for the resolution of issues in the case at bar.

In the instant case, the facts clearly show that the payments in question were not disproportionate to the rents reserved under the original lease (fixed rents were reserved under the lease agreement of 1953 for the lease years commencing November 1, 1954, November 1, 1955, November 1, 1956 and November 1, 1957, in the amounts of $1,600,000; $1,700,000; $1,700,000 and $1,800,000, respectively. Thereafter, a rental based upon a percentage of the lessee's gross rent receipts from its tenants was reserved, with a minimum guaranteed rental of $1,000,000.00 per year). (Jt. Ex. 3-C, pages 3 and 4)

And when the $80,000 payments are viewed in the perspective of the leasehold as expanded by the supplemental lease agreement, case law premised upon evidence of substantially disproportionate payments becomes totally inapplicable.

Other cases cited by the Tax Court lend little, if any, support to its conclusions. *Oscar L. Thomas,* 31 T.C. 1009 (cited by the Tax Court at R-32, 23) tends to support the petitioner's position. In that case the Tax Court, in allowing the deduction claimed by the taxpayer, observed at page 1012:

> "There is nothing in the record to indicate that the parties were not dealing with one another at arm's length or that the rental was unreasonable, or that there was some undisclosed agreement that a portion thereof was to represent the cost of acquiring a leasehold interest."

Similarly, there is nothing in the record of the instant case to indicate that the parties were not dealing with one another at arm's length, or that the rental was unreasonable, or that there was some undisclosed agreement that the additional rental was to represent the cost of acquiring the increment to the leasehold interest.

The following cases cited by the Tax Court have so little factual similarity to the case at bar that their citation contributes little force to the Tax Court's conclusions.

Alexander W. Smith, Jr., Executor, 20 B.T.A. 27 (1930) (cited at R-32), involved the question of deductibility of payments by a "lessee" under an agreement which allowed the "lessee" to obtain title to the "demised" property by payment of $10.00 to the "lessor" at the end of

the "term". A fee simple deed to the premises was deposited in escrow by the "lessor" to be delivered to the lessee upon compliance by the "lessee" with the terms of the agreement. The court determined that the "lease" was in fact an installment sale contract, and that the payments were therefore purchase installments rather than rents.

In *Lola Cunningham*, 39 T.C. 186 (1962) (cited at R-33), the decision sustained the *taxpayer's contention that the payment in question was an advance rental* and was deductible in the year designated for its application by the parties to the lease agreement.

Joseph J. Neel Company, 22 T.C. 1083 (1954) (cited at R-33), involved the question of whether the taxpayer-lessee could amortize and deduct an alleged obligation to improve the demised premises or to pay in lieu of such improvements a stipulated sum at the end of the lease term. *The taxpayer contended that the alleged obligation was the acquisition cost of the leasehold*, and as such was subject to amortization and deduction over the term of the lease. The Commissioner claimed that the obligation was contingent and, therefore, not subject to amortization or deduction. The Court held that the obligation was fixed and not contingent, and that the taxpayer could amortize and deduct the obligation over the term of the lease.

E. This court's review is not limited by the "clearly erroneous" rule.

Int. Rev. Code 1954, 26 U.S.C. §7482 provides in part:

> "The United States Courts of Appeal shall have exclusive jurisdiction to review the decisions of the

> Tax Court, except as provided in Section 1254 of Title 28 of the United States Code, in the same manner and to the same extent as decisions of District Courts in civil actions tried without a jury. . . ."

Rule 52(a), Federal Rules of Civil Procedure, 28 U.S.C., sets forth the rule relating to review of findings of fact by a trial court in civil actions tried without a jury. Rule 52(a) states in part:

> "Findings of Fact shall not be set aside unless clearly erroneous, and due regard shall be given to the opportunity of the trial court to judge the credibility of witnesses."

The evidence in the instant case consisted entirely of stipulated facts and documents. The Tax Court based its decision principally upon its construction and interpretation of the lease agreement and supplemental lease agreement (Jt. Exs. 3-C and 4-D, respectively). The Tax Court was not called upon to weigh testimony or judge credibility of witnesses. Under these circumstances this court is concerned not with questions of fact and the "clearly erroneous" rule, but with questions of law. In ascertaining whether or not the supplemental lease agreement is ambiguous as written and construed, and in interpreting the lease agreement and the supplemental lease agreement, this court is not bound by the findings or inferences of the Tax Court, for in such matters the court is principally concerned with questions of law. *Republic Pictures Corp. v. Rogers*, 213 F.2d 662, 664, 665, (9th Cir. 1954).

The misplaced reliance of the Tax Court upon the rent abatement clause together with the fact of the parties' express characterization of the payments as rentals, both

in word and deed, militate against a characterization of the payments as anything but current rentals. There is absolutely no evidence in the record to support a characterization of the rentals as advance rentals, and no basic facts or inferences drawn therefrom, except those which were tainted with error in law or with misinterpretation by the Tax Court of documentary evidence, which would support a conclusion that the payments should be characterized as capital expenditures.

An additional error of law is implicit in the Tax Court's reliance upon its assertion that:

> "Petitioner would receive no income from the use of the property added to the original lease during the years here involved, at least until the Washington Building was rented and completed." (R-33).

The tacit legal conclusion of the above is that current deductions may not be taken for payments connected with non-income producing properties. The error in this legal conclusion is exemplified by *Flambeau Plastics Corp., supra,* pages 17-18. Where the trial court's findings are induced by, or its conclusions based upon, an erroneous view of the law, the same are not binding on the reviewing court. *Smallfield v. Home Insurance Co. of New York,* 244 F.2d 337 (9th Cir. 1957); Vol. 2B, Barron & Holtzof, *Federal Practice & Procedure,* §1137, pp. 559-561.

II. The Tax Court Erred in Concluding That the $80,000 Payments Were Not Deductible as Ordinary and Necessary Expenses Under Int. Rev. Code, 1954, 26 U.S.C. Sec. 162(a).

A. The Tax Court applied an erroneous standard of deductibility.

The Tax Court concluded that the $80,000 payments constituted the consideration for the acquisition of the Post Office tract, and that such payments were, therefore, capital expenditures. Int. Rev. Code 1954, 26 U.S.C. §162(a) contemplates the deductibility of *ordinary and necessary business expenses,* including rentals or other payments required to be made as a condition to the continued use or possession of the demised property. The Tax Court denied the deductibility of the payments by petitioner on the ground that:

> "* * * We have no evidence that the petitioner was *required* to make these $80,000 payments in connection with the *everyday operation* of its business." (Emphasis added) (R-36)

Thus, the standard of law applied by the Tax Court equated the terms "required" and "everyday operation" to the terms "necessary" and "ordinary", respectively, appearing in §162(a). Where the conclusion of the trial court is induced by a misapprehension of the applicable legal standard, the conclusions must be rejected as clearly erroneous. *Mitchell v. Raines,* 238 F.2d 186, 187 (5th Cir. 1956).

To be "ordinary and necessary" an expense need not be one required to be made in the everyday operation of a taxpayer's business. The applicable standard of law, as distinguished from the erroneous standard applied by the Tax Court, is illustrated by the following citations:

> "An expense may be ordinary even though it happens but once in the taxpayer's lifetime. For an expenditure to be necessary, it is not essential that there be an absolute and compelling reason. When the expenditure is appropriate and helpful to the taxpayer's business, the courts are loath to override the

taxpayer's judgment." *Cravens v. Commissioner of Internal Revenue*, 272 F.2d 895, 898, 899 (10th Cir. 1959).

"When is an expense necessary? An expense will be ordinarily considered 'necessary' if the expenditure is appropriate and helpful to the development and maintenance of the taxpayer's business. Obviously, under such a view, the necessity is not absolute or inexorable." Mertens, *Law of Federal Income Taxation*, chap. 25, p. 24.

"The concept of 'ordinary' under the Code does not require that the expenditure be either habitual or normal in the sense that a taxpayer makes or is required to make them often; the expenditure may be ordinary even though unique or non-recurring to the taxpayer affected." *Ibid*, page 27.

"The non recurring nature of the disbursement does not preclude deductibility; nor does its mere dollar amount. Expenditures made in accordance with trade usages and the requirements of good practices may be deducted, even though there is no legal obligation to make them. Similarly, expenditures made to retain or protect and promote the normal continuance of an established business are deductible, as are expenditures made to retain customer good will." *Connecticut Light & Power Co. v. United States*, 299 F.2d 259, 264 (Ct. Cl, 1962).

It is evident from the above that the Tax Court failed to apply the appropriate legal standard of deductibility to the facts of this case. It follows that the Tax Court decision must be reversed.

B. The evidence supports the deductibility of the payments as ordinary and necessary business expenses.

Assuming, for purposes of argument, that the Tax Court's conclusion that the payments herein were consideration for the acquisition of the Post Office parcel incre-

ment to petitioner's leasehold, it does not follow that the payments made by petitioner were to be capitalized, and that the same were not currently deductible. The following case law supports the deductibility of the payments made by petitioner herein as ordinary and necessary business expenses.

In *Wyoming National Bank of Casper, Wyoming,* 23 B.T.A., 408 (1931), the taxpayer deducted as additional rentals payments of $10,000 each in the years 1922 and 1923, in addition to the yearly rental of $10,000 reserved under its lease. The additional rentals were consideration for speeding up construction of a building to be occupied by the taxpayer on the leased premises, and to cover the costs of certain alterations and improvements in the building requested by the taxpayer. The evidence showed that at the time in question the taxpayer was quartered in an old building which was unsuited to its business and inadequate. The improvements, alterations and betterments requested and paid for by the taxpayer were of a permanent nature. The deductions of the "additional rentals" were disallowed by the Commissioner and were characterized by him as capital expenditures to be amortized over the term of the lease. The Tax Court concluded that the amounts paid by the taxpayer in consideration of the lessor's speeding up the construction and making the improvements were not capital expenditures and held that the Commissioner erred in disallowing the claimed deductions.

The facts of the instant case require the same result. As recited by the Tax Court, (R-29), the building located on the side adjacent to the Post Office tract was the "smallest and least profitable" of the

Metropolitan Tract buildings; an inadequate building, unsuited to petitioner's use of the demised premises.

The motivation for the inclusion of the Post Office tract was illustrated by the Supplemental Lease Agreement:

> "* * * said lease (1953) *requires* the lessee to operate the various structures then or thereafter constructed upon the demised premises in such a manner as not to injure the reputation thereof and to maintain the demised premises as a center of store and office buildings of the first class, and at all times to so operate the tract as to produce the maximum return consistent with the character of the tract; and
>
> "* * * the parties have determined that, in order to accomplish these purposes and to produce a maximum return for the lessor and to preserve and improve the status of the tract as a business center of the first class, the contemplated new building to replace the Douglas Building should be located on its present site enlarged by the addition of an adjoining tract now a part of the present Post Office site and which is described as follows * * *" (Emphasis added) (Ex. 4-D, p. 1).

The duty of petitioner to its lessor to undertake and fulfill the obligations set forth in the lease agreement of 1953 and the supplemental lease agreement; i.e., to maintain the character of the originally demised premises as a center of store and office buildings of the first class, existed by virtue of contract. Thus, the necessity for petitioner's expenditures herein was more compelling than that set forth in the *Wyoming Bank* case.

But even lesser degrees of "necessity" will suffice under §162(a). In *Cubbedge Snow*, 31 T.C. 585 (1958), the taxpayer, a law firm, was allowed to deduct

as ordinary and necessary business expenses expenditures made by it to cover losses incurred by a federal savings and loan association organized by the taxpayer. The taxpayer had organized the association to provide a new source of abstract fees for its law business, in order to fully utilize the taxpayer's abstracting books, files and records which it had accumulated over previous years. There, as here, the Commissioner had disallowed the taxpayer's claimed deduction as being a capital expenditure. The Court stated:

> "The crucial and controlling factor lies in determining whether the acts done and expenditures made were motivated by the purpose to protect or promote the taxpayer's business or made as an investment in a new enterprise." p. 591.

> "While capital expenditures ordinarily result in the acquisition of assets having periods of useful life in excess of one year it does not follow that an expenditure must be deemed a capital outlay merely because the ultimate benefit may accrue in a year or years subsequent to the year of payment." p. 593.

The Court further explained its position by distinguishing *Carl Reimers Co.*, 19 T.C. 1225, 1239 (1953) as follows:

> "The outlays there were not made, as they were in the instant case, for the purpose of protecting, retaining or adding to the business which the taxpayer already had, but to fulfill a prerequisite to the attainment of something new." p. 593.

The court concluded that the payments were deductible by the taxpayer.

Again, assuming the Tax Court's conclusion that the payments were here made for the acquisition of the Post

Office property increment to petitioner's leasehold, the purpose of the acquisition was to protect or add to the business which the petitioner already had, as is indicated by the language in the supplement lease agreement quoted *supra*, p. 28.

That expenditures to meet demands of business change and competition are deductible is illustrated by *Connecticut Light & Power Co. v. U.S., supra,* p. 26. There, the taxpayer claimed a deduction for the total costs incurred by it in converting its business from the distribution of manufactured gas to the distribution of natural gas. To accommodate this change, the taxpayer altered its distribution pipelines and fittings and its customer's burner units in order to handle the dryer, higher BTU rated natural gas. The court concluded that expenditures made in the "normal continuance of an established business" are deductible. That term encompasses the situation where a taxpayer incurs an expense to up-date and in fact to change in nature the assets of his existing business. The scope and philosophy of the court's opinion is illustrated by the following statement:

> "In this competitive, fast moving age, there is no such thing as industrial stand-still." *Ibid,* page 266.

Where expenditures are made by a taxpayer for the acquisition of an asset as an incident to the conduct of its business, such purchase being motivated by business rather than investment purpose, the asset so acquired is properly characterized as a non-capital asset. The loss, if any, realized on the sale of such an asset is characterized as an ordinary and necessary business expense and is fully deductible under Int. Rev. Code 1954, §162(a). *Commissioner of Internal Revenue v. The Bagley &*

Sewall Co., 221 F.2d 944 (2nd Cir. 1955). (Government bonds purchased as security for a performance of contract); *Booth Newspapers, Inc. v. United States*, 303 F.2d 916. (Ct. Cl 1962) (Purchase of plant and inventory of newspaper manufacturers in order to insure supply to taxpayer). Although these cases deal with losses, the significance of their holdings lies in the characterizations of the acquisitions as non-capital assets. This characterization is dependent upon the motivation of the taxpayer, whether for business or investment purposes, for the acquisition. The motivation for the execution of the supplemental lease agreement is quoted, *supra*, page 28, and constitutes a clear expression of the petitioner's motivation, and that of its lessor, to add the Post Office tract as an incident to the business operation of the originally demised premises. (The premises added by the supplemental lease agreement constituted an area of only 4,400 square feet (R-21), and the stated purpose for its acquisition was to enlarge the Douglas Building site to facilitate the construction of the Washington Building). There is no evidence of a motivation to acquire the Post Office tract increment to petitioner's original leasehold as a separate investment property.

CONCLUSION

Because of the nature of the record on this review, the evidence consisting entirely of stipulated facts and documents, this Court has the power to reverse the Tax Court and to enter its decision in favor of petitioner. Based upon the following conclusions, respectfully urged by petitioner as being supported by the facts and law

presented herein, such reversal and decision by this Court is fully justified.

1. The characterization of the payments as current rents is supported by their designation as such in the supplemental lease agreement and the clear distinction in said agreement between the additional rents reserved and the consideration for the inclusion of the Post Office tract. Moreover, the mutual treatment of said payments as current rents by the parties to said agreement is compelling evidence of such characterization.

2. Even if not characterized as current rents, the evidence supports the characterization of the payments as ordinary and necessary business expenses, made to protect and promote petitioner's existing business.

3. The Tax Court's conclusion that the payments were not current rents is premised upon the assumed but clearly erroneous fact that the premises were non-income producing during the periods in question; and upon the equally erroneous legal conclusion that the rent abatement clause of the original lease would have been applicable during the period in question.

4. The Tax Court's conclusion that the expenditures were not ordinary and necessary expenses was based upon an erroneous construction of 26 USC 162(a) (Int. Rev. Code 1954) and the resulting application of an improper standard of law to the facts herein.

Respectfully submitted,

DeWitt Williams
Attorney for Petitioner

CERTIFICATE

I certify that, in connection with the preparation of this brief, I have examined Rules 18 and 19 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with these rules.

DeWitt Williams
Attorney for Petitioner

APPENDIX A

Table of Exhibits Pursuant to Rule 18(2)(f) as Amended:

Joint Exhibits		*Offered*	*Admitted*
1-A	U.S. Corporation income tax return of petitioner for fiscal year ended October 31, 1961	R-61,62	R-62
2-B	U.S. Corporation income tax return of petitioner for fiscal year ended October 31, 1962		
3-C	Lease agreement between petitioner and University of Washington, dated July 18, 1953	R-61,62	R-62
		R-61,62	R-62
4-D	Supplemental lease agreement between petitioner and University of Washington, dated February 5, 1958	R-61,62	R-62

NOTE: Exhibits E, F, G and H were offered by respondent (R-62). Petitioner objected to their admission (R-62). The Tax Court did not rule on their admissability for the reason that it did not consider such Exhibits in rendering its decision, and stated that said exhibits were not the best evidence and were of little probative value. (R-35)